The impact of the country risk on direct foreign investments in the countries of Central and Eastern Europe

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I. Context

Among the various methods of entering a new market that a company has available in the internationalization process, foreign direct investments stand out due to the benefits observed both in the host country as in the source country. Foreign direct investments allow multinational companies to greater high control over their international activities, to avoid trade barriers, especially tariffs, or to exploit their comparative and competitive advantages. However, according to OECD 2008 and UNCTAD, 2006, foreign direct investments flows can contribute to the economic development of the host country by ensuring integration into the global economy, creating new jobs, increasing productivity, technology transfer and managerial skills, but also by increasing workforce skills.

The conceptual framework of the determinants of FDI is widely debated in the specialized literature since the 1930s. Motivations underlying the internationalization through FDI are for the first time investigated by Ohlin (in Feath, 2009) which states that higher profitability rates offered by full growth countries are able to auto finance themselves at low interest rates and overcome tariff barriers are the main reasons to choose FDI. Eclectic paradigm or OLI model proposed by Dunning in 1997 (cited in Hauser, 2005) summarizes the reasons for the decision to internationalize through FDI into three categories: ownership advantages, location advantages and internalization advantages. Based on OECD and IMF definitions with the benchmark proposed by Dunning theorizing, UNCTAD 2006 divides the factors that influence foreign direct investments in the following categories: market search, search for resources and search for strategic assets. Determinants of FDI in market search are represented by advantages like size, or potential of the new market structure. Gross Domestic Product (GDP) or the population are the most used variables as a proxy for the market size while GDP per capita or the population growth are used to measure its potential. The determinants of FDI in the search of efficiency offers multinationals the opportunity to get winnings from the international investment synergies obtained through the international integration of production. Labor productivity, added value, openness to trade and cost reduction are the measures most commonly used in the econometric research. The search of resources is used by multinational companies to ensure the safety production process through the availability of raw materials, natural resources or cheap labor provided by the host country.

But like any investment decision, foreign direct investments are subject to inherent risks and the uncertainty of the potential profit. In the case of FDI, the specialized literature notes the prevalence of a particular type of risk, the country risk which includes several categories of risks like: economical risk, transfer risk, political risk, sovereign risk and currency risk (Daniels et. Others, 2007 Hauser, 2005; Nordal, 2001 Meldrum, 2000). These components of the country risk are landmarks in the analysis which the multinational companies do on the host country. On the other hand, profit is the other side of the coin. The investor may be interested in a high risk investment but with a comparable earning potential (Brighman and Erhardt, 2005).

II. Issues

In this context, the paper entitled: "The impact of country risk on direct foreign investments in the countries of Central and Eastern Europe" aims to examine the relationship between foreign direct investment and the country risk, with reference to Central and Eastern European countries, the country risk is defined as the likelihood of events that result in exposure to a potential loss of a real asset / business due to the occurrence of economic events, political or social which are under control of the government of the host country and not under the control of the owner good / manager company.

Based on the definition, we can say that the country risk represents an essential component of the overall risk of operations in the international environment. It is generated by the interaction of a variety of political, economic and social factors which manifests as a complex reality of a country that affects any investment located in that geographic area.

The appearance of the concept of country risk is related to the nationalization of the Suez Canal in 1956, a decade after former British colonies, French, Dutch gained their independence, metropolises maintaining economic ties that were established in the colonies era. The events of instability in the regions which became economic and administrative independent, determinate significant losses for the investors of former cities, especially because of the frequency of political instability and the attitude adopted by the new government towards foreign investors. However, the event that brought the country risk in the attention of the experts was the revolution in Iran in 1979, which brought losses of a billion dollars for companies who operated on this market, but the revenues generated by the oil exports made relatively easy to honor the external financial obligations. Contrary, Nicaragua, whose leader was supported by the U.S for a long time was overthrown by revolutionaries, highlights the differences between the two countries due to economic factors, respectively, supporting the economy through exports, in the case of Iran, and the weakening economy due to the earthquake of 1972, in the case of Nicaragua determined the inability of support in the service debt without exterior intervention.

Recent events, referring here to the economic crises that the states of the world have crossed over the past three decades, bring also in the foreground the analysis of the country risk, especially quantifying its accuracy and relevance.

Although the concept of country risk has experienced extensive theorizing in literature, it continues to raise problems for researchers. Diversification of the forms of internationalization and the international financing caused confusion regarding the forms of manifestation of the country risk, to the definition of the transfer risk as incapacity of payment or considering political risk as a country risk and not as a component of it.

From the limited perspective of the concept, namely, sovereign risk, perceived only in the international lending, researchers have diverse opinions because of the concrete cases of exposure to country risk of the other forms of internationalization. Even though the evaluation methodology is relatively the same, both for international lending and foreign direct investment, exists differences in terms of scope, time horizon for which the analysis is done, the forms and the probability of the risk materializing and last but not least, how to analysis and risk management

Monitoring the country risk for foreign direct investment is fundamental in taking an optimal investment decision or location of production in a given country.

Those mentioned highlight the importance and topicality of the research topic built around current and future problems. Questions like: To what extent the country risk affects the decision of a multinational company in investing in one country or another? The methodology for quantifying the country risk in the context of the economical crisis is correct and appropriate? There is a correlation between FDI inflows and country risk? If so, in what way does it manifest? They are current but they will be of interest also in the future.

The research undertaken is up to date because it is based on the analysis of permanent economic realities change, both nationally and internationally, the country risk represents in fact an actual diagnostic and a predicting potential attractiveness of an economy, hat captures the economical performances, the quality of the business environment and also the quality of formal and informal institutions in a country.

The modeling factor of FDI inflows on receiving countries' economies makes the analysis of the relationship country risk- foreign direct investments to be of strategic importance to the governments concerned.

Moreover, placing the analysis in the countries of Central and Eastern Europe, which have undergone a period of transition from socialism to capitalism, characterized by the ability to choose every ideal combination of external and internal forces shaping their economic and social evolution, makes the theme chosen to be one of great interest both descriptive and empirical. Following the path chosen by each of the countries in transition towards a market economy, can be determined differences regarding the role that was given to foreign capital as a generator of development.

Placed in the same geographic area and based on some common historical background, you might think, mistakenly, that the perceived country risk within these states is the same. Reality shows that investors decide according to the economic, political and social concrete evolutions from the countries concerned, any deviation from the path toward a sustainable economic growth or indecision at the administrative level is charged by shifting capital. This is why Romania, for example, a country with great potential for attracting FDI, both because of market size, but also because of the possibilities of developing the companies through qualified and relatively cheap human resource, fails to achieve the target of foreign direct investment flows. Thus, relative to the same variables, other CEE countries are proving to be more able to compensate for the shortcomings of this level by offering a stable and predictable investment climate (see the Baltic countries).

III. The purpose and the objectives of the research

The research will be build around the main objective of undertaking this work, namely to analyze and highlight the role of the country risk in attracting FDI flows. Considering the economic, social and political evolution of the countries of Central and Eastern Europe, it is considered that the analysis of both quality and quantity, of the impact of the country risk has on FDI inflows.

The main objective will be achieved through the following sequential objectives:

Objective no 1. The conceptual delimitation of the country risk and the clear definition of its components: sovereign risk, political risk, transfer risk, also it will be comparatively analyzed the country risk afferent to the international lending and the one afferent to the foreign investments with the purpose of highlighting on what the impact of country risk will be on the decision to internationalize a multinational company as in choosing the form of internationalization;

Objective no 2. Comparative analysis of the main methods of measuring the international country risk: Moody's, Standard & Poors, Fitch, The Economist Intelligence Unit, Euromoney, International Country Risk Guide, the purpose is highlighting both the differences and commonalities in approach of the evaluation of the country risk through the methods proposed by the specialized agencies in order to highlight the role of rating agencies in economic crises (the Asian crisis in 1997-1998 vs. present economic crisis);

Objective no 3. Analysis of the theoretical and empirical determinants of FDI and the highlights of the role of literature for country risk as a factor of FDI;

Objective no 4. Comparative analysis of FDI flows received by the countries of Central and Eastern Europe in the period 1990-2012, and empirical analysis of what the impact of the country risk will be on FDI inflows in these countries, using the principal component analysis will summarize the similarities and differences between the 10 states;

Objective no 5. The orientation of the research towards Romania involves qualitative analysis of foreign direct investment inflows and country risk on its constituent components, even if the country risk analysis is ex-ante investment process, the Romanian business environment analysis from the perspective of foreign investors through the Enterprise Surveys shall be carried out in order to provide those interested in possible solutions to improve the business climate, equivalent to reducing country risk and more importantly attracting FDI flow.

IV. Methodology

Moving from the theoretical development to the practical approach presume the use of analytical methods that apply according to the particularities of the domain, of the factors that must be anticipated, as the time horizon for which the required estimate.

Used in the research conducted, analysis and synthesis represent complex methods, interrelated and which condition each other. The analysis and synthesis method has a retrospective character, as a prospective character, and it has been used in our study because of the need of a thorough investigation of the phenomena studied, namely, foreign direct investment and country risk over a period of 22 years, but also because their quality of generalization of these phenomena.

The analysis, as a general method of studying reality consists in breaking phenomenon into its component parts to study them through the causal linkages that involve them, linkages with other elements, the trends manifested in order to know the root causes , not only to the immediate.

The analysis and synthesis method involved the following sequence: a) the observation of the phenomena and the processes based on relevant information obtained from databases internationally recognized as UNCTAD and Eurostat; b) decomposing each phenomenon into its component parts and studying their equivalent analysis of FDI flows and country risk, component and unitary: c) revealing the causes that determined the evolution of the studied phenomena; d) structuring the factors with direct action and those with indirect action, the decomposition of each factor based on factors derived; e) determining the correlations between the elements and between them, and the analyzed phenomenon; f) quantifying the influence of various factors, using well established statistical program SPSS 17 and Eviews 7; g) the development of synthesis, by the influence of the factors, estimated forward and in accordance with the assumptions made.

In our approach we use macro analysis as the basic method of studying the economic realities and relationships established in the national economies. Macroeconomic analysis used is an inductive one, starting from general to particular aspects, and dynamic, capturing and highlighting changes over time between economic phenomena and processes studied.

In terms of content, the macroeconomic analysis used in our approach is both qualitative and quantitative. The qualitative analysis, respectively the analysis of the socio-economic content of the subjects, namely the economies of Central and Eastern Europe, it is necessary to lead to theoretical generalizations. From our point of view, the qualitative analysis undertaken must be completed and even supported by quantitative analysis.

Since our approach involves the analysis of the economic phenomena for the countries in Central and Eastern Europe, it is necessary to use the international comparisons method. It has been imposed an increased attention to the comparability of the data at the levels both qualitative and quantitative. The comparison in time and space was used because of the need to study the evolution of some phenomena which are taking place around the same time or slightly delayed in the analyzed countries.

V. Summary of the main parts of the thesis

Based on the purpose, objectives and methodology used in our research, we have structured the research in five chapters, as follows:

Chapter 1 - *Trinomial Multinational firms - Country risk - Internationalization*. Conceptual approaches capture the internationalization as one of the most important development levers of the global economy. Beginning with an overview of the evolution of the multinational firms in economic theory, we highlight the role of the risk in the international business. Analyzing the many risks that a company may face on foreign market, we Bend our attention towards the country risk. This is presented under the conceptual, methodological and causal aspect. The methodological analysis of the sovereign risk analysis directs our attention to the role of rating agencies in the economic crises.

Chapter 2 - *Relationship FDI- country risk. The theoretical, empirical and managerial perspectives* shows the evolution of the main economic thinking that has analyzed FDI theories. The analysis of the specialized literature highlights a new trend in the investigation of the determinants of FDI at an empirical level namely the institutional approach. Addressing the relationship foreign direct investments- country risk from the management perspective pinpoints the role of the country risk analysis in the internationalization through FDI and key management methods that can be applied by multinational firms to reduce potential exposure to such risk materializing.

Chapter 3 - *Methodological aspects concerning the statistical analysis of the impact of the country risk on foreign direct investment* provides a synthetic image of the main indicators used in the analysis of FDI and the country risk. The purpose of this chapter is to introduce the main variables that will be used in the empirical research to be undertaken in the following chapters.

Chapter 4 – *The country risk - determinant of FDI in the countries of Central and Eastern Europe* is the main contribution of the author's descriptive and empirical analysis of the impact of the country risk on CEE countries. Often analyzed together, the 10 countries of Central and Eastern Europe have different evolutions at ideological, economic and social levels. All this is reflected in the country risk perceived by the foreign investors and, therefore, in the attracted foreign direct investment flows. The research shows that although some CEE countries have significant advantages in terms of size and market potential, they fail to attract FDI in the amount expected, which is explained by how each state can manage the transition opportunities which all countries have crossed it, reflected mostly by the levels of the country risk. Therefore we expect to confirm the hypothesis that a high level of risk determines lower FDI inflows.

Chapter 5 - *Romania - between risk and opportunity. The role of business environment in attracting FDI* captures the major developments in FDI flows related to the detailed analysis of the economic component of the socio-political and country risk. Plus the value of this chapter is given by the Romanian business environment analysis from the perspective of foreign investors present in the market. This was achieved as a result of access provided by the World Bank's primary database questionnaires applied in the Enterprise Surveys 2002, 2005 and 2009.The workings of the author highlights the main obstacles with witch the investors are confronting, therefore, he proposes some solutions to improve the investment Romanian climate equivalent to improvement of the country risk perceived and the attraction of FDI in a higher volume.

CONCLUSIONS

Located in attention of researchers for several decades, foreign direct investment still remain a broad research topic, which has not lost its importance, but more in the context of the economic and social realities constantly changing, we consider an perpetual FDI analysis necessary, both in terms of the expected benefits but also of the determinants.

In this context, our approach is built around foreign direct investments and their determinants in the countries of Central and Eastern Europe, represents a challenge because of the unique experiences that each country has encountered in the transition process from a centralized economy closed to foreign capital to a market economy, where domestic firms compete with foreign ones.

Among the main determinants of FDI, this paper attempts to provide a pertinent and comprehensive analysis on the impact of the country risk over this type of capital flow, built around several questions: To what extent the country risk affects the decision of a multinational company to invest in one country or another? The methodology for quantifying the country risk in the context of economic crisis is it correct and appropriate? Is there a correlation between FDI inflows and the country risk? If so, in what way doe it manifest?

The research conducted highlights the importance of the theme not only because it is conducted in the countries of Central and Eastern Europe, less investigated in the specialized literature, but also because it is given a special attention to the economical, political and social development reflected in the country risk, in order to highlight similarities and differences between them in an attempt to determine the aspects that have influenced over time the foreign direct investment flows.

In order to achieve the main objective of this paper, namely analyzing the relationship between foreign direct investment and country risk, we structured our research around five sequential targets.

Browsing the specialized literature, according to the objective 1, has highlighted the importance of the internationalization process both at a macroeconomic level, respectively for the global economy and at a microeconomic level, for the company in question, of its determinants, we stop approach on the sovereign risk and the role it plays in the decision of internationalization and the choice of form of internationalization. Thus, multinational companies will choose a joint venture (joint venture) in countries considered riskier because such a method of internationalization involves sharing the risk with local partners, and foreign direct investment "on their own" in countries with medium stable and predictable business.

The measuring of the country risk is a highly debated topic in the specialized literature, especially in times of global economic balance. Thus the accomplishment of objective nr 2 involved a comparative analysis of methodologies used by rating agencies in assessing the sovereign risk in order to highlight their role in the financial crisis in Southeast Asia and in the current sovereign debt. It appears that rating agencies provide foreign investors a basic tool that is the rating, the easiest way to reduce information asymmetry characteristic to the international capital markets. The analysis of the two economic crises shows us the post-event reaction of the rating agencies and not ante as we expected. Moreover, it seems that their actions equivalent to the successive relegation procedures of the countries affected by the crisis, from the risk classes with investment character in speculative classes, sometimes even with 10 classes of risk, were interpreted as a pro-cyclical element in the evolution of the global capital flows. The b behavior of rating agencies has been criticized because, initially, led to capital inflows, ensuring high investment yields through the circumscription of the countries concerned into investment classes, but also at the compression economies of the countries concerned, because with worsening prospects for the country risk or with the demotions generated by the real economic development there are occurring massive withdrawals of foreign capital from these markets, as a result the economical situation of the countries is getting worse, not having access to foreign capital markets considered by potential investors to be too risky to invest and the rating agencies continue to downgrade the rating, thus creating a vicious circle from which, according to the experience of the analysis, they can't get out without the external help or the help of the international institutions (see case Asian countries between 1997-1998 and, more recently, that of Greece).

Summarizing the main theories of FDI, according to objective3, has been necessary for highlighting the most important determinants of FDI. According to the specialized literature, specific determinants are found for the new theories of trade, but also for the institutional approach. Among them it is establish that the country risk is one of the variables commonly used both as a composite indicator as well as its sub-components, in the econometric analysis undertaken at the levels of some extended samples of countries or just at the level of some groups of countries, such as those in Central and Eastern Europe or the BRICS countries.

The 4th Objective has targeted the analyses between the foreign direct investment and the country risk for the countries of Central and Eastern Europe in 1990-2012, we used econometric modeling for the FDI, using as a method the multivariate regression for panel data, building our approach around 3 hypotheses about the impact of important determinants of FDI, in which we have included the country risk, whose verification was performed using the statistical program EViews 7 the whole sample:

Hypothesis no 1- an increase in GDP / capita, proxy for economic development, namely the market potential will increase FDI flows, our analysis shows that the influence of GDP / capita. on the FDI is statistically significant with a confidence level of 90%.The positive coefficient shows that there exists a positive relationship between the two variables analyzed, which confirms the hypothesis in the analysis from which we have begun: the more the host market potential grows, the more it will attract more foreign direct investment. In our case at the level of the whole sample, a 1% increase in GDP / capita would generate a 1,536% increase in FDI inflows.

Hypothesis no. 2- an increase in demand, expressed by the population size, will cause an increase in FDI. As we expected, the hypothesis is confirmed, there is a strong positive relationship between this variable and the FDI inflows: the more the local demand grows, the more the country attracts a higher level of FDI. The coefficient of 2.396 indicates that a 1% increase in the variable POP generates a 2,396% increase in the FDI attracted by all the 10 countries analyzed.

Hypothesis no. 3- a lower country risk, determines high inflows of FDI. The country risk expressed by the aggregate indicator measured by the International Country Risk Guide is also significantly correlated with FDI inflows. In our case an increase in the amount of the country risk (0 - high risk, 100 - safe business environment), equivalent to a lower perceived country risk, determines an increase in the volume of FDI.

The challenge of what the country risk analysis presumes for the developing countries such as those in Central and Eastern is an accurate quantification of the extent of the structural changes that were needed for these countries to move from a centralized economy to a market economy. Starting from a highly centralized system with distorted prices and inefficient producers in most economic sectors there was necessary to create both the legal and institutional structure for a market economy and a fair competitive environment.

The FDI play more and more important role in the economies of the countries from ECE, but the distribution of the total volume of FDI attracted by the region is unequal, as it is showed in our analysis, from quality and quantity point of view, as a consequence of the presence of several factors as: concrete economical conditions from each country, the political and social stability.

The reforms of the transition had place in the context of maintaining new political and economical actors. The most important governmental policies from the point of view of our analysis concern the reform of the property, the restructuration of the market capital, liberating the external trade, liberating the FDI. The results and not the existence of all the reforms can be seen in the levels of the country risk registered in each estate.

The differences between the Czech Republic, Poland and Hungary on the one hand, and Bulgaria and Romania, on the other hand, can be explained by several factors: faster speed of reforms in the case of the first countries, their proximity to the EU integration in a whole community block or intense economic ties with western Europe, since the period of centralized economy.

Slovakia initially showed similar trends as Romania and Bulgaria, but since 2000, has recovered trajectory fitting in the group of Central European countries, promoting the accelerated reforms.

Eliminating the inevitable differences between the central and east European countries, the evolution of these states, which were at the level of the year 1990, on a certain similar position on some aspects, but different on other aspects, create the departing point in the modeling the importance of the FDI in the allocation of the resources on economical efficiency and competitively.

The development of the local market, the productivity of work, and the low cost of the workforce, the considerable profit rates and the possibility to access structural funds represents in our opinion the main attraction points for the new foreign investments in the ECE estates. But, it is necessary the insurance of a adequate physical infrastructure, of an educated and qualified workforce, of a favorable legislative frame and of a stable business environment

However, we should mention that the economic development of CEE countries is closely related to the medium term of the European Union for EU foreign direct investment, and foreign trade with Member States, represents the main drivers for the modernization of the economies of these states.

The 5th objective, that is, the restriction of the analysis in Romania, involved qualitative investigation of FDI flows in 1990-2012.

This highlights the positive impact it has had the major accession process and EU membership on FDI attracted by our country. Not only because the overwhelming majority of FDI inflows from EU Member States, and due process of economic and political restructuring that Romania was forced to go through to access the membership.

This process involved the adoption of an important number of reforms and their implementation, depending on the outcome, reflected in levels of country risk.

Considering Romania as the focus point of the analysis we can do the following observations: 1) a country with great potential to attract foreign investors, but over time without a coherent strategy and a strong political will in this direction, 2) the main problems encountered by foreign investors in Romania is taxation, corruption and bureaucracy.

The country risk survey of its components highlights the main problems faced by foreign investors in our country as a choice destination for their investments: the inconsistency of economic policy measures adopted, delays in the privatization programs of state assets, but also the political instability and numerous recessions and economic drift.

The empirical analysis of the impact of the country risk on foreign direct investment involves the econometric modeling in Romania, for a period of 15 years (1996-2011). Thus the interpretation of the results shows that the country risk measured by the composite index of ICRG and Euromoney, is directly correlated strongly and significantly with the entry of FDI in Romania, confirming the more specialized studies that find a negative relation between perception of the country risk and the FDI.

As a state we considered necessary development and the highlighting of the impact of specific variables for the institutional approach have on FDI flows. Thus, it appears that the index of economic freedom and governance appear as better predictors than FDI stock of FDI inflows.

Analyzing the perception of the foreign investors on the Romanian business environment, according to the processing of the World Bank Enterprise Survey questionnaire, we notice that are reported as significant obstacles in carrying out the activities the following: bureaucracy, corruption and political instability, recurrent problems of Romanian society as a whole.

We also recognize the limits of the analysis we have undertaken. We believe that such a research of the impact of the country risk, a phenomenon difficult to quantify, on the foreign direct investments is suitable for a quantitative analysis that can be implemented and supported by a qualitative one, which can track the investor's attitude towards the perceived level of the risk country. Qualitative analysis can be done by the interview method, asking decision-makers about the importance they give the country risk in their decision to locate a future FDI.

However this can be considered as a new direction of research, this current study intends only to bring in to the attention of those interested of a subject that arouse more interest and that doesn’t consume all the problems analyzed.